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Going Beyond Venture Capital and Project Financing: Strategic Alliances and M&A

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Agenda

1. Introductions
2. Overview of Strategic Transactions
3. Preliminary Considerations
4. Deal Terms
5. Joint Ventures
6. Mergers & Acquisitions



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INTRODUCTIONS

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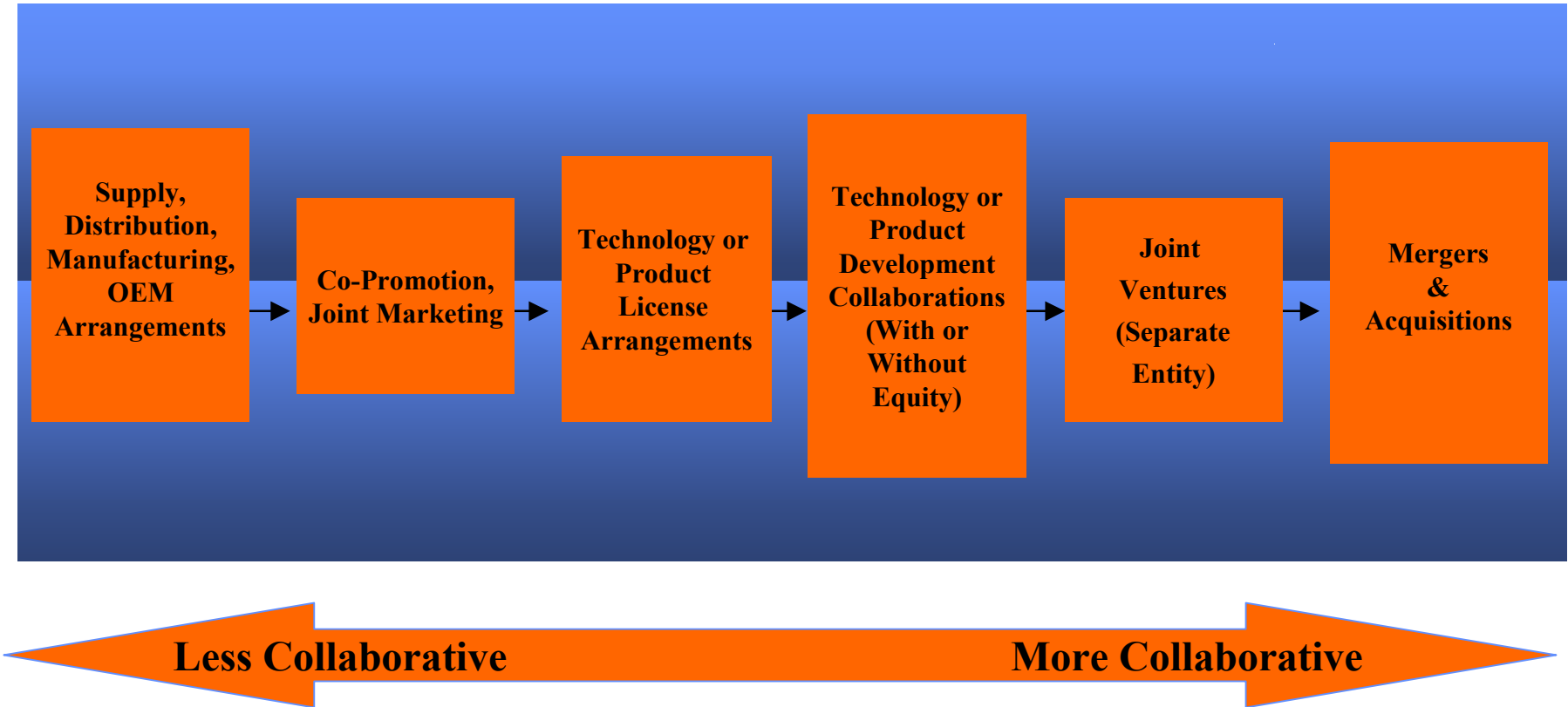
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OVERVIEW OF STRATEGIC TRANSACTIONS



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Common Types of Partnering Relationships



Strategic in Nature (Material, Long-Term)
Ongoing, Interdependent Relationship

Partnering Advantages

- To Bigco:
 - Shortening of the development cycle
 - Lower development cost
 - Developmental risk management
 - Entrepreneurial talent and technology expertise
 - Moves R&D off balance sheet
 - Pre-acquisition comfort
- To Smallco:
 - Less dilution and more control over management
 - Lower development cost, access to funds
 - Development focus, technology validation
 - Credibility and stability
 - Operational benefits, Expertise

Partnering Disadvantages/Risks

- To Bigco:
 - Lack of total control over Smallco employees or development
 - Limited control over return on investment
 - Dependence on small, unstable company
- To Smallco:
 - Loss of total control
 - Time requirements to close
 - Lack of commitment or narrow focus by Bigco
 - Cannibalization of core business
 - Restrict future growth, limit or foreclose other funding or acquisition
- To Both:
 - Cultural incompatibility
 - Decreased flexibility, dependence on partner
 - Management distraction, misalignment of management incentives



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PRELIMINARY CONSIDERATIONS



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The Partnering Process

1. Find a partner
2. First contact: Find the right person
 - Personal contacts
 - Introductory letters
3. Non-confidential information to interested parties
4. Preliminary meetings
5. NDA and exchange of confidential information
6. Scientific/technical meetings
7. Business discussions
8. Term sheet
9. Due diligence
10. Negotiation of agreement(s)

Identifying Potential Partners

- Track record of product successes, market reputation
- Collaboration reputation and track record
 - Culture, willingness to collaborate, teach and share
- Development expertise, speed to market, sales force
- Likelihood to close deal
- Evaluate fit (complementary or competitive), strategic value of your technology to the partner
- Potential candidate for merger or acquisition?
- The selection process should continue throughout the period of negotiations
 - Maintain competitive alternatives, avoid exclusive negotiations and other restrictions

Understand Objectives

(of both partners)

- Access to new technologies or skill sets?
- Access to domestic and/or international distribution channels, customers?
- Accelerate expansion of manufacturing capacity?
- Risk Sharing?
- Funding?
- Prelude to Acquisition?
- Competitive considerations?
- Validation -- of technology, market credibility?
- Marketing and sales force, experience and reputation?

Broad Issues

- Internal selling, buy-in
- Understand partner's players and approval process
 - Champions, opponents
 - Decision makers, who has authority
- Compatible objectives
- Mutual on-going incentives, alignment at every stage or outcome
- Flexibility for long-term
- Understand each partner's (and the assets') SWOT
 - **S**trengths, **W**eaknesses, **O**pportunities, **T**hreats

Due Diligence Issues

- Thorough review of IP, contracts, legal actions
- Confidentiality, NDA (mutual, time, scope)
- Remember that during due diligence, it's not "business as usual" for Smallco
 - Disruption to Smallco
 - Time (production of documents; meetings)
 - Legal and accounting cost to Smallco
 - Ego (Bigco challenges to Smallco strategy, tactics)

Communication

- Face-to-face meetings are critical
- Good communications during the negotiations, with trustworthiness, integrity and creativity, lay the foundation for a great relationship
- Both companies need people at the right level, both going in and ongoing, of
 - Seniority
 - Authority
 - Personality
 - Commitment
 - Availability
- Establish processes in the agreement that facilitate frequent, ongoing communication



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DEAL TERMS



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Scope of Rights

- Exclusive/nonexclusive
- Fields of use
- Geographic (territory) limitations
- Durational use limitations
- Permitted activities (R&D, "make, use, sell")
- Cross-licensing or grant back
- Manufacturing and supply rights
- Additional product rights
 - Right of first refusal on new developments
 - Additional license or distribution rights in new areas
- Co-promotion rights

Intellectual Property

- During due diligence: differing views on validity and scope and on clean-up needed; "battle of the experts")
- Rights in developed technology, improvements
 - Follow inventorship
 - Follow strategic interest
 - Joint or solely owned, with allocation via licenses, assignments
- Patent rights (who is responsible, who pays, recovery, step-in rights)
 - Prosecution and maintenance
 - Enforcement
 - Infringement

Financial Terms

- Upfront fees
- R&D funding (development fees)
- Milestone Payments
- Royalties
- Profit Sharing
- Transfer fees
- Sublicense fee sharing
- Stock purchase
- Be mindful of tax implications
- Reporting, accounting, audit rights

Setting Financial Terms

- Size of market for the product
- Potential market share (competitive products on the market and in development)
- Stage of development
- Research comparables
- Valuation consultants & valuation methodologies
- Negotiate with multiple parties
- Assess cost, time to market, risk, return (patent life, competition, prices, revenues, etc.)

Governance and Decision Making

- Committees
 - Product Development, Joint Commercialization, Steering, Patent Strategy
 - "Jurisdiction" of committees and subcommittees
 - Governance and decision making (management and scientific, inter- and intra-level coordination and communication)
 - Dispute resolution: clear mechanism, channels, responsibility, deadlines
- Careful re antitrust issues (e.g., pricing in distribution agreements)

Diligence, Termination

- Diligent development, commercialization
 - General (commercially reasonable) vs. specific deadlines
- Termination triggers
 - Failure of diligence, other uncured breach
 - Elective, milestone failures, competition
 - Deadlocks
 - Change of control
- Rights upon termination
 - Continuing license to terminating party (if for cause)
 - Sale of inventory
- Remedies other than termination

Dispute Resolution

- Lower-level forced to try to resolve first, report to higher-ups if they can't ("embarrassment brings resolution")
- Senior executives confer (escalate to point where pain of dispute exceeds pain of resolution)
- Mediation?
- Litigation vs. arbitration
 - Reserve the right in arbitration provisions to resolve intellectual property issues in court
 - Injunctive relief
 - Time, cost (money, management time)
- Choice of law, location, regime

Other Terms

(But not "boilerplate")

- Representations and warranties
- Indemnity and insurance
- Limitation of liability
- Non-competes, carve-outs
- Confidentiality, Publicity
- Assignment
- Force majeure



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JOINT VENTURES

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Joint Ventures

- Free-standing business with its own management, employees, finances, production assets, IP, distribution capabilities, etc.
- Risks of joint venture structure
 - Loss of control
 - Employee incentive misalignment
 - Difficult to terminate
 - Intellectual property concerns
- Clearly define business activities of partners, contributions, distributions, governance and exit strategies
- Management, employee issues
- Securities laws, tax, antitrust considerations
- Non-competition
- Transferability of interests



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MERGERS & ACQUISITIONS



Understanding the Art

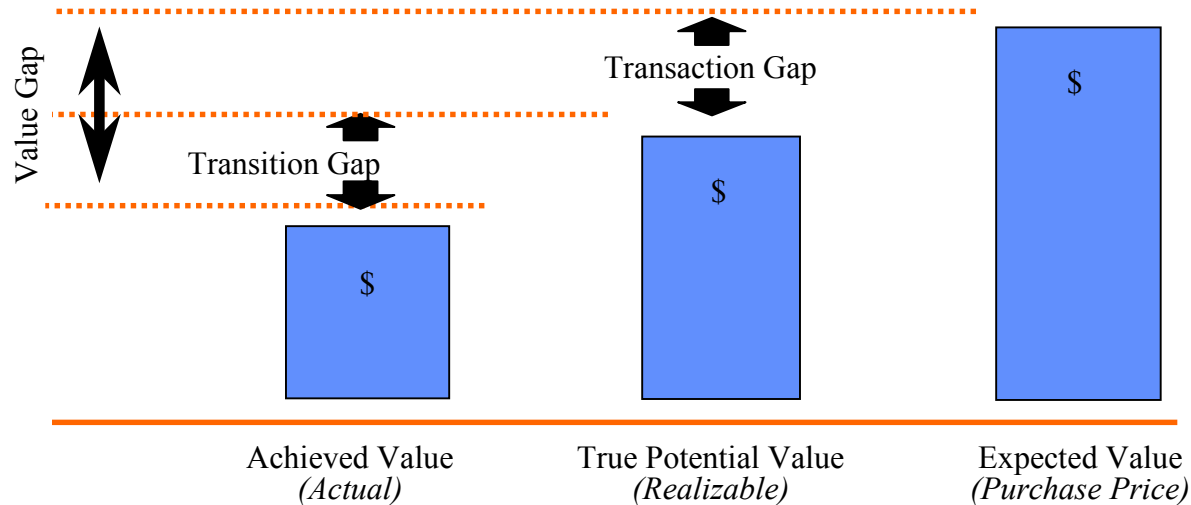
“Most mergers don’t work.”

— from *Wall Street Journal* article by Jeffrey L. Hiday,
October 12, 1998

“Most of the top executives interviewed after the research said that in hindsight they wished they had paid more attention to the mechanics of merging the companies and less to finding the target and negotiating terms.”

Hiday, *Wall Street Journal*

Understanding the *Risks*



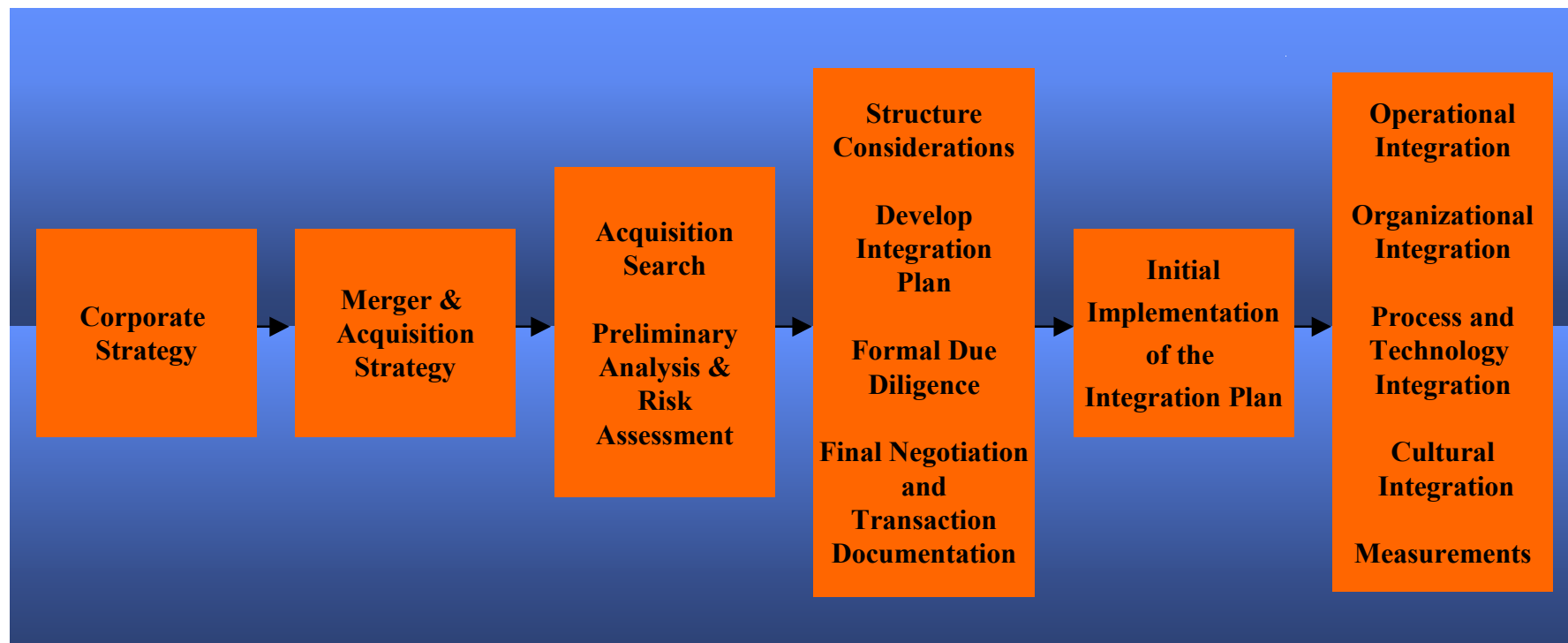
Common “Transaction” Gap Reasons for Failure

- Overoptimistic appraisal of market potential
- Overestimation of synergies
- Multiple agendas and perspectives
- Internal and external time pressure
- Limited access to information
- Historical biases
- Failure to assess implementation considerations
- Lack of prior experience in acquisition analysis and negotiation

Common “Transition” Gap Reasons for Failure

- Planning not strategic, but opportunistic or emotional
- Cultural and operational integration planning inadequate; implementation poorly orchestrated
- Evaluative metrics not defined, results not measurable
- Lack of executive focus on integration activities (lack of time and integration experience)
- Lack of an articulated vision for the combined entity
- Conflicting agendas of influential people
- Failure to maintain customer focus
- Loss of momentum in integration activities
- Flight of key talent and knowledge
- Employee uncertainty and loss of productivity

Acquisition / Transaction Continuum



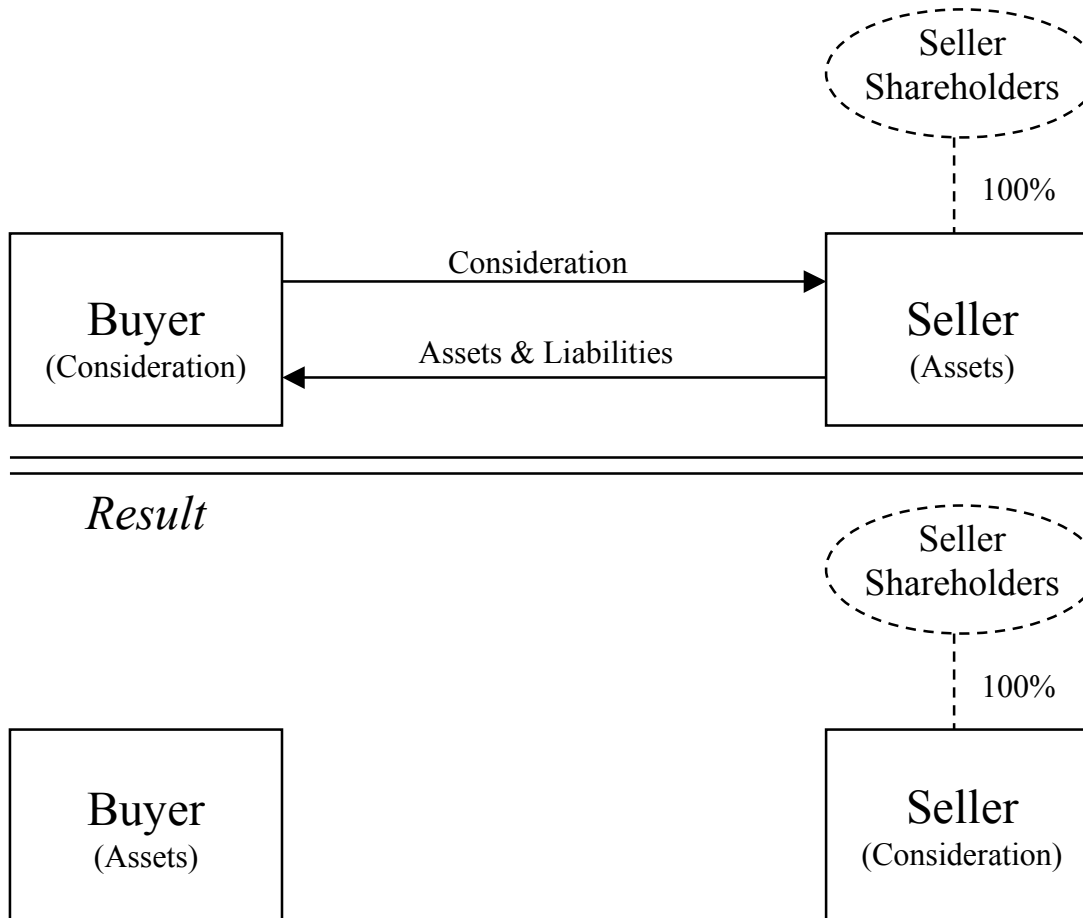
The M&A Structures

- Forms of Business Combinations
 - Purchase and Sale of Assets
 - Purchase and Sale of Equity Interests
 - Stock Purchase
 - Merger (all mergers are statutory)
 - Direct, Reverse-triangular, forward-triangular, consolidation
- Currency—Cash vs. Stock (or both)
 - Cash – straightforward
 - Stock – dilutive to Acquirer's stockholders and represents a new investment decision for Target stockholders

Asset Purchase

- Advantages to Buyer:
 - Purchase only those assets that are desired
 - Assume only specified liabilities; reduce risk of assuming unknown liabilities
 - Tax advantages—stepped up basis in the assets
- Disadvantages to Buyer:
 - Successor liability issues in some states—
 - If the buyer is merely a continuation of the Seller or the transaction was entered into to escape liability, Buyer may be on the hook for Seller liabilities even though not expressly assumed in the asset purchase agreement
- Disadvantages to Seller and its Shareholders:
 - Forced to retain certain known and unknown liabilities
 - “Bulk Sales” laws
 - Third party consent issue
 - Tax disadvantages—double taxation

The Asset Purchase

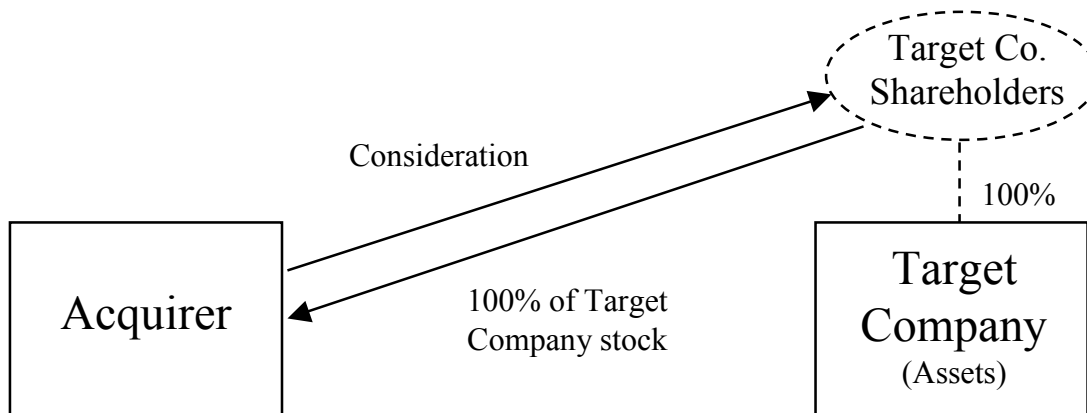


Purchase of Equity Transactions

Stock Purchase and Merger Transactions

- Advantages to Acquirer and Target Co.'s Shareholders:
 - Acquisition of all of the Target Co.'s assets
 - Acquirer may be able to take advantage of net operating loss carryforwards of the Target Co.
 - Reduces likelihood that parties will need to obtain third party consents prior to completion of the transaction
 - Tax advantages—generally structured as a tax-free transaction
- Disadvantages to Acquirer:
 - Acquirer assumes all liabilities, whether known or unknown
 - Accordingly, the Acquirer must perform extensive due diligence
 - An acquirer can limit exposure by having a separate subsidiary acquire the equity

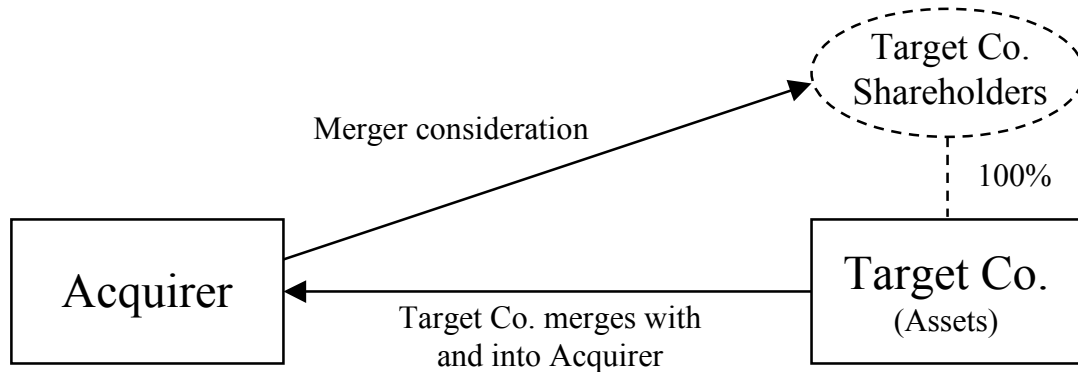
The Stock Purchase



Result



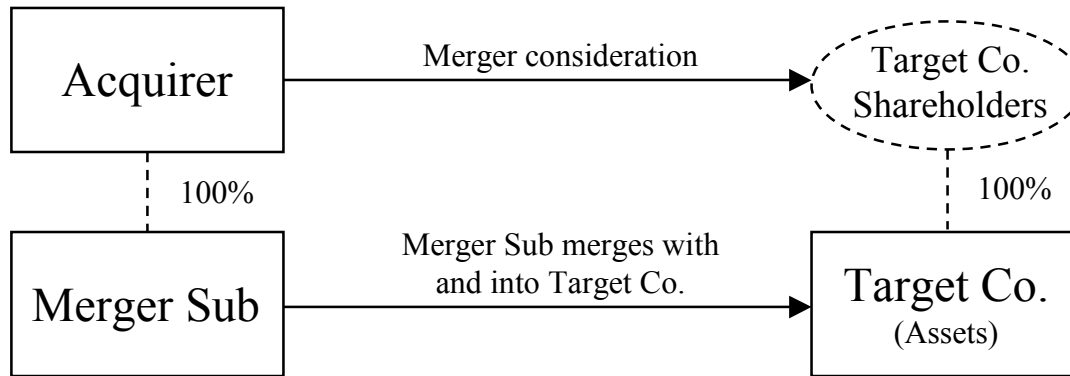
Direct Merger



Result



Reverse Triangular Merger



Result



Pricing Issues

- Purchase Price
 - Fixed dollar amount (*i.e.*, fixed value)
 - Fixed number of shares (*i.e.*, fixed ratio)
 - Post-closing adjustments (*e.g.*, based on an audited financials)
 - Earn-outs
 - Milestones
 - Percentage of consideration
 - Disadvantages
 - complicated to structure and draft
 - pose risks for both sides
 - Escrows
- Cash vs. Stock—Tax Issues
 - Reverse Triangular – 80% stock + other requirements
 - Forward or Forward Triangular – 45-60% stock
- Liquidity of stock (3(a)(10) vs. resale registrations)

Non-Price Deal Terms

- Representations and Warranties
 - Serves many functions (diligence, basis for closing, basis for remedies)
- Pre-Closing Covenants
 - No-shop
 - Conduct of business
- Conditions to Closing
 - Continued accuracy of representations and warranties as of the closing date
- Termination Rights
- Indemnification Provisions
 - Remedy for breaches of reps, warranties and covenants
 - Caps, baskets and deductibles

Effect on Preferred-Stock Rights and Stock Options

- Preferred-Stock Rights
 - A business combination may trigger special rights for preferred shareholders
 - Liquidation preference
 - Dividend preference
 - Antidilution protection
 - Special voting rights
 - Redemption provisions
- Treatment of Stock Options
 - Depends on provisions of stock plans
 - Assumption by Acquirer?
 - Acceleration of vesting provisions?
 - Automatic vs. discretion of Board of Directors

Impact of Sarbanes-Oxley

- Greater risk aversion by public buyers
 - Increased Board scrutiny (greater need for internal champion to get buy-in at the Board level)
 - Deeper focus on financial statements and internal controls
 - Concerns with related party transactions
 - Longer and more in-depth due diligence process
- Prudent would-be sellers will conduct their business accordingly

And Finally, Never Forget

The six phases of any project:

- Enthusiasm
- Disillusionment
- Panic
- Search for the guilty
- Punishment of the innocent
- Praise and honors for the non-participants



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QUESTIONS

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